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Just say no

Protecting buyers from unintended consequences of reliance disclaimers in M&A transactions

By Timothy A. Miller

Reliance disclaimers in M&A agreements generally provide that the parties relied solely upon the representations expressly stated in the agreement. Delaware and New York courts enforce these disclaimers to avoid a perceived "double fraud": the alleged extra- contractual fraud of the seller and the fraud of the buyer in falsely representing in the acquisition agreement that it did not rely on extra-contractual representations.

Buyers increasingly demand fraud carve-outs, which generally provide that various limitations in the contract apply "except in cases of fraud." But reliance disclaimers and fraud carve-outs exist in inherent tension because the disclaimer appears intended to vitiate extra-contractual fraud claims that the fraud carve-out purports to preserve.

The Delaware Chancery Court challenged buyers to just say no if they intend to preserve fraud claims: "The enforcement of non-reliance clauses recognizes that parties with free will should say no rather than lie in a contract." Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1058 (Del. Ch. 2006). There are proactive steps a buyer can take to preserve valid extra-contractual fraud claims in M&A transactions.

Reliance Disclaimers

New York and Delaware courts enforce reliance disclaimers to preclude extra-contractual fraud in M&A transactions based on the sophistication of the parties, the sanctity of contract, and the theory that vitiating the disclaimer would be to sanction a double fraud. *See Abry*, 891 A.2d at 1061; *DynCorp v. GTE Corp.*, 215 F. Supp. 2d 308, 319-20 (S.D.N.Y. 2002). They treat the disclaimer as a representation of a sophisticated buyer that it in fact did not rely on any representations not expressly stated in the agreement. Delaware and New York courts thus hold that a reliance disclaimer removes an M&A agreement from the venerable common law rule that fraud vitiates every contract.

In Delaware, the agreement must contain a clear and affirmative disclaimer "from the point of view of the aggrieved party." *FdG Logistics LLC v. A&R Logistics Holdings Inc.*, 131 A.3d 842, 860 (Del. Ch. 2016) (holding this is a "critical" distinction that "strike[s] an appropriate balance between holding sophisticated parties to the terms of their contracts and simultaneously protecting against the abuses of fraud"). New York courts require specificity but do not require the disclaimer to come from the point of view of the buyer; a statement by seller that it made no representations outside the agreement will suffice. *Harsco Corp. v. Segui*, 91 F.3d 337, 342-43, 345 (2d Cir. 1996).

Will a Fraud Carve-Out Control Over a Reliance Disclaimer?

Recent Delaware decisions suggest that strong fraud carve-outs will control over contractual limitations on a buyer's remedies, including reliance disclaimers. In *JCM Innovation Corporation v. FL Acquisition Holdings Inc.*, the Delaware Superior Court allowed fraud claims based in part on allegedly fraudulent estimates of warranty costs to proceed despite a buyer's disclaimer of reliance on "projections, estimates and other forecasts." C.A. No. N15C-10-255 EMD CCLD (Del. Super. Ct. Sep. 30, 2016). The court highlighted fraud carve-outs in the reliance disclaimer and exclusive remedies provisions, holding: "The Exclusive Remedy Provision explicitly sets forth JCM's options for claims under the Agreement. JCM can go through the indemnification process, or it can bring fraud claims."

In *Eni Holdings LLC v. KBR Group Holdings LLC*, the Chancery Court denied a motion to dismiss a fraud claim brought outside the contractual limitation period despite the absence of a fraud carveout in that provision based on fraud carve-outs applicable to the exclusive remedies provisions in general. C.A. No. 8075-VCG (Del. Ch. Nov. 27, 2013). This suggests that the fraud carve-out will control even where it is not contained in the specific provision at issue.

A buyer could argue that a fraud carve-out tips the balance between the sanctity of contract and the policy against fraud back in favor of the buyer. The Chancery Court held in *FdG Logistics* that the balance tips to the buyer if the agreement does not contain a disclaimer from the buyer's point of view. A buyer could argue that an express fraud carve-out likewise tips Delaware's delicate balance against enforcement of a reliance disclaimer where fraud pollutes the diligence process.

Under New York law, a buyer could argue that a fraud carve-out should control by the same logic underlying the enforcement of disclaimers. New York courts hold that a sophisticated buyer can disclaim reliance on the "mix of data and information supplied to it," even where it in fact has relied on such information. *DynCorp*, 215 F. Supp. 2d at 311. If so, sophisticated parties should likewise be able to use fraud carve-outs to restore a buyer's actual reliance on the "total mix" of information in cases of fraud.

How Can Buyers Proactively Guard Against Extra-contractual Fraud?

Just say no. Buyers should just say no to reliance disclaimers. The Chancery Court in *Abry* reasoned that a sophisticated buyer could adjust the acquisition price for the risk of fraud. But a buyer cannot price fraud into the deal because has no knowledge of the misrepresented facts. And contrary to the legal fiction that a disclaimer is an admission that a buyer did not rely on extra-contractual representations, a sophisticated buyer may be duty bound to consider the "total mix" of information not only in closing the deal, but also in deciding to limit a buyer's remedies.

If a seller insists, limit the reliance disclaimer:

- Limit disclaimer to specific representations *not* relied upon.
- Limit disclaimer to specific categories of known unknowns, such as forward-looking estimates.
- Request a centralized fraud carve-out that cross-refers to the reliance disclaimer, exclusive remedies, indemnification, and integration provisions.

Include rhreshold ADR. If a seller complains about litigation risk/ cost, agree to limited threshold arbitration at the pleading stage as a condition precedent to litigation, subject to heightened PSLRA-style pleading standards, and a discovery stay. The parties can also agree to a loser pays attorneys fees provision applicable at the ADR pleading stage.

Conclusion

No sophisticated buyer would agree to be defrauded. Care should be taken to preserve legitimate fraud claims through fraud carveouts.

Timothy A. Miller *founded the Silicon Valley office of Valle Makoff LLP after 14 years as a litigation partner at Skadden, Arps, Slate, Meagher & Flom LLP. Mr. Miller routinely advises buyers and sellers regarding the drafting and litigation of provisions related to post-closing disputes in M&A transactions, including contract claims for indemnification or extra-contractual claims for fraud. His practice is focused on commercial, fiduciary and securities litigation, claims of trade secret misappropriation, unfair and anti-competitive business practices and business and investment fraud. Mr. Miller is admitted to practice in California.*


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